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The Bear is doing his nasty job. What's his job? It's to move the stock market down while keeping as many people as possible IN the market. How does he do it? Periodic rallies, rallies that convince people that "all is well." Rallies that keep people wondering, if "we are really in a bear market." Plus, of course, the usual bullish blather from media and Wall Street "experts" who haven't a clue as to what's really happening.

Richard Russell, Dow Theory Letter, Sept. 9, 1998

Now The Great Reckoning

The greatest bull market of all times in financial markets is finished, not only in the agonizing economies of the emerging countries but also in America and Europe, where the economies are still looking in good shape. Even there, though, apparent overabundance of euphoria and liquidity have vanished with a vengeance.

It is necessary to understand how a collapse of this stunning rapidity and magnitude could have happened. The answer is that around the world an unprecedented excess of hot money and credit has savagely destabilized economies and financial systems. Unfortunately, this does not only apply to the emerging countries. At the center of these excesses, is their most powerful and most aggressive promoter at home and abroad—the U.S. financial system.

The world economy has been caught in the greatest financial debacle since the Great Depression of 1929-32—with one important difference: The financial excesses of the last three or four years are by far the worst in history.

We have been waiting for the unavoidable final collapse of this grossly overheated global financial boom. Still, the speed with which it unfolds strikes us as ominous. We are left with one question: What will be the aftermath? In short, a mind-boggling excess of debt and credit tends to herald mind-boggling destruction.

ASKING HISTORY AND THEORY

Supposedly, a bear market implies an average decline by 20 percent. But what really matters is what happens after such a fall. Unweighted, the 6,600 stocks traded on the two stock exchanges in New York have already lost about 40 percent, on average. The breadth of these losses is disastrous. The stock indexes containing the blue-chip stocks mask the fact that the vast majority of stocks had not taken part in the bull run.

Could the current bear market get much worse? While others ask their charts, we search history and theory for clues. As to history, the fact is that the bears, though greatly feared, have in general been a rather docile species. Yet even these mild species have come in very different shades. The shockingly steep drop of U.S. share prices in the bear market of late 1987 by 36 percent took two months. Nevertheless, the world economy boomed, and all the losses were recovered within two years. The last bear market, that of 1990, was a lot milder. A decline by 21 percent unfolded over three months, but six months later, the market began to hit new highs.

This century has seen two extremely severe bear markets, wreaking devastating havoc not only on the U.S. stock market but also on the economy. They occurred in 1929-32 and 1973-74. The former, with an average

decline of 90 percent, ushered in deflation and the Great Depression of the 1930s, and the latter, with an average decline of 70 percent, augured the Great Stagflation of the 1970s—sluggish economic growth with high rates of price inflation..

What is the outlook for this bear market? Sharp but brief? Or deep and long with big economic troubles, resembling the two disastrous cases? This is the question to be answered now in a hurry before losses compound. Commenting on the various types of bear markets in history and their implications, an author in the Financial Times recently implied that the past is a poor guide because the two devastating species, mentioned above, had significantly different causes—credit crunch and deflation in the first case and inflation in the second one.

We hold the opposite view. These two devastating experiences, though so different in their appearance, do provide valuable clues for assessing the risks lurking in the current bear market. To this end, the first thing to see is that the two big crashes had by no means different causes. The author confuses causes and effects. There never was a severe crash without a prior explosion of credit. All crashes have their genesis in prior monetary looseness and excess credit.

Inordinate credit expansion had actually preceded both crashes. But what dramatically differed was the pattern of the unfolding inflation as well as the pattern of the subsequent crisis. In 1929-32, the overheated boom ended in savage debt and price deflation, whereas in 1973-74 it ended in unprecedented consumer and producer price inflation. Why this difference?

In the 1920s, the excess money and credit had overwhelmingly poured into financial assets, both bonds and stocks, fueling rampant inflation in their prices while the conventional price indexes had remained absolutely flat. As opposed to this mold, the money and credit excesses of the late 1960s and early 1970s had overwhelmingly cascaded into rising demand for goods and services, inflating their prices, in particular those of tangible assets. This time, it was the turn of the financial assets to slump.

DIFFERENT TYPES OF BEAR MARKETS

Weighing these two severe bear cases, we note in the first place that they both occurred against the backdrop of a synchronized, serious global crisis. This is what clearly distinguishes them from all the other bear markets. Without having investigated every single case, we are sure that all the other incomparably milder bear markets had one common single cause: monetary tightening at the height of the conventional business cycle which mostly played out within one year. In brief, they were "cyclical bear markets." This short-term nature of theirs had its chief reason in the fact that the business cycles consisted of mainly inventory fluctuations.

The unfolding current bear market is not of this cyclical lightweight type. All too obviously, it belongs to the global heavyweight type, of which this century has seen but two, albeit they differed according to the prior genre of inflation: 1929-32 was preceded by rampant asset inflation, and 1973-74 was preceded by rampant product inflation.

OMINOUS PARALLELS

For a long time, it has been clear to us that the economic and financial development of recent years has striking parallels to the pattern of the 1920s. The outstanding features in both periods are unbridled financial speculation and an explosion in international credit, with two important qualifications: First, the famous, frenzied stock market boom of the 1920s, unlike the 1990s, was not global but confined to the United States.

Second, the excesses in stock valuations and the financing of the speculation of the 1920s make for very modest reading in light of the 1990s.

There is wide agreement in hindsight that developments in the United States in the late 1920s were crucial to the sharp downturn in the world economy as a whole. Yet it started outside the United States, particularly in Europe and Latin America. During the 1920s, America had flooded the world with credit, allowing many countries—with Germany as the biggest borrower—to run unsustainable trade deficits. But the more Wall Street boomed, the more it became an irresistible magnet for foreign money, in particular through high-yielding broker loans. As international credit flows consequently dried up, the drastic retrenchment that followed by the debtor countries dealt the world economy its first blow through plunging imports. Thus, the world's march into the Great Depression did, strictly speaking, not begin with the Wall Street crash but with the earlier global credit contraction. In the summer of 1929 the U.S. economic boom petered out.

Historians agree that in the 1920s international lending went grotesquely to excess and that its disruption powerfully contributed to the later world economic collapse. However, we hasten to add that the international credit excesses of the 1920s have been a children's game compared to what has happened in the 1990s. Most importantly, the difference is not only in magnitude but also in the type of financing. During the 1920s, all the international lending was in the form of straightforward bank loans or mainly bond purchases from individual investors.

HOT MONEY IS NOT CAPITAL

International lending in the 1990s has been of a diametrically different kind. The name of the game has no longer been the investment of savings by individual investors but highly leveraged speculation by hedge funds and international banks recklessly exploiting the existing big interest rate differentials between low-yielding and high-yielding currencies, borrowing in the first and investing in the second. The single biggest provider of funds at ultra-low interest rates, well below 1 percent, has been the near-bankrupt Japanese banking system—by way of the famous yen carry trade. The main recipients were the high-yielding currencies of Latin America, Russia, Canada, Britain. But the biggest single recipient was the United States, in particular U.S. Treasuries.

The label "capital flows" for these flows, which run into hundreds of billions of dollars, has in our view always been a gross misnomer. Capital comes from savings and this money sloshing around the world had not the slightest relation to savings. It is "hot money" of the worst possible kind because it is not merely short-term money. These huge flows have overwhelmingly resulted from highly leveraged international money creation through the international banking system. With the new computer and information technology at its disposal, the speculative community is able to move multibillion dollars within seconds just by pushing a few buttons. In essence, this is tantamount to printing money at random.

American economists and Wall Street pundits in particular have elevated unimpeded capital flows between countries to a most important condition for spreading wealth around the world, arguing that it raises world prosperity as a whole by allowing capital to go to the places of the highest return. This is preposterous. The money sloshing around the world in the past years was out for one thing only: quick, maximum profits through reckless international interest arbitrage with the highest possible leverage. Economic development has no role in the decisions of the financial speculators. These flows have done far more to destabilization than help the economic development of these countries.

The patent fact is that free capital flows, to use this misnomer, actually serve only the unmitigated interest of America in general and of Wall Street in particular. First, with its minimal domestic savings and the pernicious huge deficits in its current account the U.S. economy is heavily dependent on persistent, enormous capital inflows. Second, the vastness of its financial system enables the U.S. economy to absorb any potential money inflows without serious policy complications. Third, Wall Street possesses a vast and flexible institutional framework to exploit the profit opportunities offered by free global commerce in money.

In contrast, the rest of the world has the common problem that for single countries the immense potential of these hot money flows, regularly concentrating on single countries or groups of countries, is completely out of proportion to the absorptive capacity of their economies and financial systems. During the years 1995-97, the developing countries had to absorb an overall capital inflow of $650 billion, of which $560 billion were net financial inflows, as against an overall current-account deficit of $250 billion. This monstrous money inflow could not fail to savagely imbalance the main recipient countries. A visible emblem of the excess was the $250 billion—or nearly 40 percent of the total—which the central banks bought and recycled into U.S. Treasury bonds. But while the dollars involved were returned to the United States, the central banks had nevertheless correspondingly inflated the domestic money supply in these countries.

THE HEDGING BOOMERANG

We keep obstinately emphasizing two theses. The first is that economies and financial systems are not shattered by monetary tightening but by credit excesses that throw them out of balance. In Asia, Russia, and maybe soon in parts of Latin America, this thesis no longer needs any proof. Our second main thesis is that the global financial excesses perpetrated in the last years are by far the worst the world has ever seen. In the logic of the first thesis, those excesses essentially presage an intractable global crisis.

Nevertheless, we have kept wondering, how those excesses in the credit and asset markets could have ever gone to such schizophrenic extremes. Apparently, it has to do with a lot of things, not only with loose money and low interest rates We see three major influences: the tremendous high tech improvements in information and trading; stupendous financial innovations (particularly the option and futures markets); and a profound change in the psychology and the expectations of the market participants.

The high tech and financial innovations, in particular, went to the heads of the people in the financial intermediaries. They mistook technical perfection for personal perfection allowing them to take unusual risks and to promise investors fabulous rates of return. Faced for some years, indeed, with fabulous profits in the stock markets, investors developed an unprecedented greed for more and more of such quick, big profits. Aspirations to deliver, on the one hand, and expectations to receive, on the other, became obsessive. On top of this, in the United States, came the hubris of the "new paradigm" economy, believed to ensure strong growth, low inflation and low interest rates forever. Inherently, this notion further implied the absence of any serious risk.

The startling meltdown of the Russian financial system revealed stunning risks in the pursuit of big profits. Russia has effectively defaulted on at least $200 billion. But what dramatically accelerated contagion was the fact that the International Monetary Fund allowed—or was forced to allow—Russia to effectively default on these debts. Now there's a true "systemic problem;" the Asian-Russian crisis has spilled over with a vengeance to Latin America, as leveraged players and global investors alike dump the securities of emerging countries all around. The entire market for emerging countries is, in effect, closed.

The options and futures markets look to have played a key role, first, in supporting the global credit

excesses by engendering the notion that other high-risk investments could indeed be protected with derivative "insurance;" and second, by regularly implementing the immediate implosion of currencies and markets as traders' dynamic hedging causes massive cumulative selling. Instead of offering protection, the hedging operations become the leading cause of a self-feeding downward spiral.

This observation that hedging everywhere badly misfires, induces us to some principal remarks about its sense and senselessness. It concerns what the old economists used to call the "fallacy of composition." This stresses the fact that collective and individual action of the same kind can have diametrically opposite effects. In the last letter, we already touched upon it with reference to liquidity effects. If a minority of investors sells shares, those investors improve their liquidity, but collective selling pressure essentially ends in nothing but wealth and liquidity destruction for all by plummeting asset prices. In the past years, the mass flight out of cash balances and into equities, boosted their liquidity. Conversely, the current flight out of equities and back into cash balances leads only to a massive destruction of overall liquidity. That's not paradoxical, that's logical.

Being aware of this fallacy of composition, we have always been more than doubtful about the prevailing notion that options and futures markets do offer effective protection from risks, as is generally believed. This is certainly true in a market without an overpowering trend, that is, where the buying and selling of options between options traders (banks and financial institutions) and their customers is fairly balanced, and where therefore little or no delta (neutral) hedging by the option traders comes into play.

But once a certain trend becomes overpowering, the option traders are forced to protect themselves by creating corresponding counter positions in the cash market, called delta hedging. In this case, heavy selling or buying in the options and futures markets translates with full force into the cash markets. The protection becomes illusory. Considering further that the options and futures markets offer splendid opportunity for highly leveraged speculation, they essentially tend to reinforce any one-sided trend. In other words, when these instruments are most needed for protection, they become destructive.

THE GREAT DEPRESSION

The Wall Street bear market of 1929-32 stands out as the one that wielded the greatest havoc ever on wealth and economic growth around the world. Worst hit among the industrial countries were the United States and Germany. Why the United States? During the whole of the 1920s it had zero inflation, as exorbitant productivity growth offset the price effects of credit inflation. And with the current account of its balance of payments in persistent, substantial surplus, the United States had become the world's greatest creditor. It was an economy of truly excellent health.

How, then, could this economy, endowed with such superb fundamentals, suffer such a prolonged, deep depression? As we pointed out in the last letter, two diametrically opposite explanations vie with each other: The one—predominant at the time—puts the chief blame on the inordinate credit excesses during the boom as the source of gross economic and financial imbalances and dislocations, impeding the economy's future growth. The other explanation—postulated in hindsight mainly by American monetarists—completely ignores these excesses and declares that the zero inflation in the conventional price indexes was compelling proof of the absence of inflation during the boom. This view puts the whole blame for the following depression on policy mistakes of the Fed committed after the crash.

We have always been a firm believer in the first explanation, primarily put forth by the Austrian school. It emphasizes that the decisive critical factor in inflation is not the behavior of the conventional price indexes but

that developing credit excesses inherently cause serious maladjustments in the economic and financial structures. Their magnitude, then, is what largely determines the intensity of the later crisis.

In understanding the booms and busts in contemporary Japan and Asia, this theory has, in actual fact, been indispensable. During its bubble phase in the late 1980s, Japan's price indexes showed no trace of inflation. Consumer prices hardly moved while wholesale prices actually declined. Judged by the stable price level, the economy thus appeared in splendid balance. In hindsight, everybody has meanwhile realized that it was in reality an economy extremely out of balance. The ostentatious emblems of roaring excess were in the exploding credit aggregates and the rocketing prices of stocks and land. Here, of course, was the conspicuous parallel with the New Era of the 1920s in the United States. And what about parallels between the U.S. New Era of the 1990s and that of the 1920s?

UNPRECEDENTED FINANCIAL EXCESSES

We come to two key points in our considerations about the probable severity of this bear market. It really boils down to two questions: How big are financial and economic dislocations inflicted during the boom and what can we expect governments and central banks to do to prevent the worst?

Trying to answer these questions, the first thing to see is that, as explained, the financial excesses that have this time occurred in the financial markets across the world, are by far the worst in history. They are so monstrous that no comparison makes sense. For sure, it was loose monetary policies by central banks that fueled these excesses in the first place. But the impact of this monetary looseness on the financial markets was virtually multiplied by the application of ever more complicated and daring financial innovations in conjunction with the new computer and communication technology.

In past letters, we have again and again chronicled particularly striking financial excesses unfolding in the U.S. financial markets, being the obvious global pacesetter in this respect. But what we branded as vicious excess appeared to the bullish consensus as a virtuous circle, sanctioned by the falling inflation rates in the price indexes.

Historic experience, though sparse, and a bit of logic suggest, that asset price inflation tends to create far greater financial and economic dislocations than normal consumer and producer price inflation. This has two plausible reasons: first, it is the one kind of inflation, however rampant, that enjoys public support, making people feel richer; and second, central bankers having learned nothing from history, traditionally ignore asset prices as an indicator of ongoing inflation, allowing it to go to extreme excesses.

Hence the proven high propensity of this specific brand of inflation to end with a particularly disastrous aftermath. Specific to the painful aftermath of a bubble economy are a wrecked financial system and debt deflation for consumers and corporations. Just look at Japan and Asia as the latest frightful cases in point.

Being asked, how nasty the present bear market in stocks may yet become, we can only refer to two earlier remarks: first, consider the monstrosity of the financial excesses; and second, consider that this crisis engulfs the whole world economy and above all the global financial system, like in 1929. Judging by these two gauges, we have to warn: Prepare for the worst.

Our second question was: What can we expect from governments and central banks to prevent the worst? In this respect, too, we note equal, utter complacency, primarily among American economists, not only on Wall Street but also from universities. One economist, whom we have always appreciated for his generally critical views, Paul Krugmann of MIT, stunned us recently with an article in *The Wall Street Journal*, in which he stated:

"In the end, a global slump is quite an easy thing to prevent.... Mr. Greenspan turned a stock market crash into a real-economy nonevent in 1987. He can do it again."

Like most others, even on highest level, the professor completely fails to see the fundamental difference between the global conditions in 1987 and today. At the time, successive, sharp hikes in interest rates shattered the markets, while the world economy was in excellent shape. In fact, it was on the verge of a synchronized expansion. This time, the crashing stock markets are hitting a global economy and financial system that are most vulnerable from past financial excesses.

U.S. ECONOMY: MESS NOT MIRACLE

Without any question, the U.S. economy will play the crucial role in shaping the unfolding world economic crisis. From all sides we hear and read comforting declarations that the U.S. economy is in excellent condition, underpinned by excellent fundamentals. Unbelievably, this goes with the further happy notion that the U.S. economy has avoided major excesses and imbalances that might put its sustained growth in jeopardy.

We can only say that this perception is ludicrous. Both the U.S. economy and its financial system are riddled with excesses and imbalances of phenomenal magnitude, making it a bubble economy. We expect it to slow suddenly and sharply under the impact of four increasingly adverse influences: shrinking exports owing to the international credit crisis; escalating wealth destruction through the plunging stock market; accelerating erosion of corporate profits; and a rapidly developing credit crunch for lower-grade borrowers of investors and lenders grow averse to risk.

The notorious difficulty of American economists to recognize the existence of perilous excesses or imbalances in the economy and the financial system has its root in the traditional, yet fallacious perception, that the absence of rising inflation rates in the conventional price indexes essentially reflects the absence of inflationary excesses.

On the surface, for sure, the U.S. economy retains immense stamina. A favorite argument for its superior staying power is that consumer spending, accounting for two-thirds of GDP growth, is well supported by heady real income and employment growth. Fine, but what is the source of this extraordinary strength in the growth of consumer incomes? In short, a bubble economy, stupid.

A "bubble economy" develops when an asset price bubble directly leads to higher spending by consumers or corporations. In Asia, the bubble effect went overwhelmingly into overinvestment. In the U.S. case, the bubble effects have most conspicuously gone into higher consumer spending. In turn, the resulting consumer spending spree fueled the strong consumer income growth. Together, it makes an absolutely clear case of a bubble economy that is highly vulnerable to a reversal in the stock market boom.

The striking evidence for this is in the phenomenal plunge in the personal savings ratio. Since 1993, this ratio has virtually collapsed from 6 percent of disposable personal incomes to virtually zero. An economy where that happens is really monstrously out of balance. While plaudits slap Alan Greenspan on the back for having delivered a well-balanced dream economy, he has in actuality allowed the U.S. economy to become grotesquely imbalanced.

NEXT: GROWING DOLLAR TROUBLES

The other, even more conspicuous token of the U.S. economy's existing massive imbalance is, of course, the huge and growing gap in the current account which has surged to annual record rate of $ 230 billion. With utter amazement, we note that the consensus nevertheless forecasts a strong dollar. We see the dollar in a long

slide, making, in due time, new lows against the European currencies.

It is our opinion that the dollar is and remains in a long-term bear market. Yet it does have temporary cyclical rallies, like the one it has enjoyed since 1995. These bull phases for the dollar regularly happen when the U.S. economy accelerates relative to the rest of the world, chiefly Europe because the rising trade deficits tend to be offset by increasing capital inflows. Basically, these dollar rallies are of cyclical nature while its long-term decline is of structural nature.

The dollar's sudden stumble took most forecasters by surprise. They had expected it to remain firm, primarily because they believe the economy's in excellent shape, assuring higher interest rates than in Europe and Japan in the long run. Instead, the financial markets have begun to reckon that the next move in U.S. interest rates will be down, both for domestic and international reasons.

Dollar bearishness is spreading, but it is still pretty mild. We are not aware of anyone who is predicting a sharp fall to new lows against the European currencies, as we do. Our primary consideration is with the U.S. economy's mammoth current-account deficit and astronomic foreign indebtedness because the stability of the dollar depends on uninterrupted huge capital inflows. But these are conditioned by the appeal of the economy and its financial system to foreign investors and lenders. Bullish financial markets, high U.S. interest rates relative to Japan and Europe, and an extremely positive perception of the U.S. economy's long-term health and strength have been made a most attractive mix for foreign investors for the last three years. This has boosted the dollar despite the rocketing trade deficit. Now, all the necessary conditions for attracting foreign capital are being shattered.

Our second major bearish consideration for the dollar is that the greater part of the huge U.S. capital inflows over the last years came not from genuine foreign investors but from two sources which have dried up. One is the dollar purchases of central banks, mostly invested in U.S. Treasury bonds. These amounted in total to about $450 billion during 1994-1997. Over the last 12 months, however, central banks have been net sellers of $90 billion in U.S. Treasury bonds. Given the global financial distress, these sales are sure to continue.

The other source of capital and probably a more dubious source of dollar strength has been the highly leveraged international yield-curve speculation, above all practiced by U.S. hedge funds and money center banks. As long as this speculation expanded, purchasing high-yielding U.S. assets with borrowed low-yielding currencies, it was wonderfully bullish for the dollar. But once these positions have to be unwound, the painful bearish part begins. In this light, we ascribe the dollar's surprising weakness against the yen largely to the unwinding of such speculative positions. Once these get under water, they have to be closed, however cheap the borrowed currency may be. In essence, such unwinding implies dollar selling against yen and other currencies borrowed for this speculation, which will depress the dollar while boosting these currencies.

Financial Boom Turned Bust

On August 6th the soon to be merged BankAmerica and NationsBank ran a joint four-page advertisement in the *Financial Times* vaunting their recent investment banking accomplishments. The first page began with a one inch headline "THE FUTURE HAS NEVER LOOKED BETTER. BankAmerica Helped Clients Raise Over $330 Billion Of Debt Capital In The First Six Months Of 1998." A description of the various categories

of debt issuance followed over those two pages. On the third page, under the headline "JUST A GLIMPSE OF WHAT'S TO COME. NationsBank Montgomery Securities reported to have completed more than $335 billion of debt, equity and advisory transaction in the first half of 1998." The enormity of this security issuance, especially coming from what had been traditional banking institutions, is staggering, solid evidence that Wall Street was out of control.

To all appearances, these bankers were completely oblivious to the financial hurricane that was to strike within days. Some dark clouds had been accumulating. But a euphoric and reckless Wall Street chose to look the other way and proceed with the greatest and most patently egregious credit boom in history, selling over $1 trillion of new debt instruments including almost $120 billion of junk bonds in the first seven months of 1998. Chase traded at its record on July 31, the day after *The Wall Street Journal* ran an op-ed piece from a well-known MIT professor titled "Growth Forever" and a caption "The bear will get gored."

What transpired, instead, was the piercing of the U.S. credit bubble. The implosion of the $200 billion Russian Ponzi scheme readily exposed the dangerous defects and fragile underpinnings of the global financial system. Numerous reports of big losses revealed the key force that had driven the bull market in U.S. domestic and global credit issuance: unbridled financial leveraging. As hedge funds and international banks suffered severe losses in Russia, the result was wholesale dumping of securities to meet margin calls and to mitigate losses.

As news surfaced that several major hedge funds were completely wiped out, others severely impaired and the international banking community suffering billion dollar losses, the hitherto ignored subjects of leverage, financial speculation and derivatives then became the focus of considerable media interest. And, at the top of the list of banks announcing large losses were institutions that we, in past letters, have chronicled in some detail, once under the heading "When Banks Become Casinos" Chase Manhattan, BankersTrust, Citicorp, BankAmerica, and JP Morgan were among the biggest losers, as we expected. So far, their stocks have lost nearly half of their value. Leading on the downside, BankersTrust has declined almost 60%. Previously, capturing our attention, we wrote "BankersTrust looks much more like a highly leveraged hedge fund than a bank..." and "$6 billion of equity supports $140 billion of assets, of which only $20 billion are loans. Trading assets are at almost 900% of equity."

Well, to update our previous analysis, as of June 30, BankersTrust had apparently continued to increase its exposure to financial markets. The bank now supports an even more stunning $172 billion of assets with $5.5 billion of equity. And, to make matters worse, this most meager sliver of equity is soon to be smaller as the company has already announced $350 million of trading losses and a loss for the quarter of at least $200 million. Moody's, rather late in the day, recently warned that it is considering a debt downgrade. Investors, no longer pondering about the health of BankersTrust, have already increased the spread on the bank's 10 year bonds by 175 basis points compared to a year ago, 100 of those basis points in just the past weeks.

Actually, credit spreads for Wall Street firms, money center banks and financial institutions have widened dramatically across the board. Persistent rumors question the solvency of several of the most aggressive major firms, and investor angst mounts regarding the lack of transparency in determining risk levels. The markets prior ability to ignore the proliferation of risky endeavors, particularly in derivatives, proved portentous but such complacency is likely a thing of the past.

In a previous analysis of Chase Manhattan we wrote, "The off-balance sheet derivative positions are outright astronomical. In just six months, they show a startling rise of 20% to $7.4 trillion. How can anyone look at this and not see an accident waiting to happen!" Today, a serious financial accident looks unavoidable, and likely

imminent, as Chase also has ignored trouble and increased exposure. Interestingly, in an analyst's conference call meant to calm fears, a top Chase executive artfully fielded question after question related to Chase's exposure to emerging markets. He was, however, unable to answer a simple question regarding the size of Chase's total derivative exposure, stating instead that he was unaware of this number which, anyway, was not meaningful.

Well, just days later a government report clarified Chase's problematic position, stating that as of June 30, Chase had a derivative exposure of $8.3 trillion, fully 12% greater than at year end. This is with shareholder's equity of less than $23 billion supporting total balance sheet assets of $367 billion, including $55 billion of securities and another $34 billion of debt and equity trading assets. And, confirming a startling revelation from the conference call, Chase now has actual credit exposure, balance sheet receivables from derivatives, of $40 billion. According to American Banker, "Chase Manhattan Bank was the only one of the top eight banks to increase its credit exposure relative to risk-based capital. At June 30, Chase's credit exposure from derivatives contracts was 334.3% of its capital, up from 325.7% on March 31." Hence, Chase now has counterparty derivative exposure that could potentially wipe out equity. With this in mind, our interest was certainly piqued with Chase's announcement of losses in Russia. Now using the word "direct" when discussing exposure, Chase management appears to be deceptively quiet on potentially catastrophic losses from less than fully "direct" positions including mounting counterparty derivative exposure.

THE GLOBAL DERIVATIVE MONSTER

We now suspect that a systemic problem exists in the global derivatives market. While the total amount of Russia's hopelessly insolvent banking system's derivative positions is unknown, huge counterparty defaults are now reality. Knowing this, we are keenly focusing on a risk far greater than Russia—the imploding Japanese banking system.

Losses to the Japanese banking system have mounted to both unfathomable and unmanageable levels. Standard and Poor's recently revised its estimate of Japan's problem loans to $1.1 trillion or a stunning 30% of GDP. In addition, for quite some time, Japanese banks have been major derivative players to inflate profits. Furthermore, Japanese banks were aggressive players in writing currency derivative contracts throughout Southeast Asia prior to the region's meltdown. In total, reported Japanese bank derivative positions at the end of March were more than $16 trillion or about five times GDP. The risk related to this exposure was brought to light recently as rumors circulated widely that Fuji Bank, Japan's sixth largest, was stuck with derivative losses of almost $23 billion. There is talk of total derivative losses for Japanese banks at a staggering $180 billion.

Japanese authorities have fought against allowing the collapse of major banks, most notably the Long Term Credit Bank of Japan, because their significant derivative exposures could destabilize markets globally, but time and alternatives are quickly running out as any semblance of confidence fades. In such an environment, a derivative loss is much more problematic than a bad loan that can be left unattended on the books indefinitely. A derivative contract is settled at maturity with parties exchanging cash. The estimated $180 billion of Japanese bank derivative losses are the other side of derivative receivables such as Chase's $40 billion.

In the July letter, under the heading "The Implosion of the Global Financial Markets," we wrote "Looking at Latin America, we see clear signs of trouble." Today this looks like a gross understatement as the region teeters at the brink of an Asian-style catastrophe. The highly leveraged hedge fund community, money center banks, and Wall Street firms are in retreat. Previous speculative "hot money" is attempting to flee. This only spurs severe crisis and outright panic. In Brazil, which accounts for 45% of Latin America's GDP, financial and economic meltdown look unavoidable. To support the overvalued currency, interest rates were raised to 50%.

But with a budget deficit of 7.8% of GDP, these rates can only prove self-defeating, strangling the economy and adding almost $5 billion to the monthly deficit because Brazil's government debt has an average maturity of just seven months, and fully 60% is indexed to overnight interest rates. Next door in Argentina, trouble brews as the country must deal with a $10 billion external deficit and intense capital flight.

THE EPICENTER: UNITED STATES AND WALL STREET

Nevertheless, the greatest negative surprises are looming in the United States where a major lack of understanding prevails. Wall Street's credit floodgates are suddenly closing fast as security issuance shrinks to a trickle. After averaging more than $16 billion monthly, the junk bond market has literally shut down to new borrowings. Spreads to Treasuries have soared to 516 basis points, up from 292 basis points in April. But the overriding problem is illiquidity. Leveraged players are being forced to sell, but few cash buyers can be found.

Interestingly, some of the biggest recent losses were in junk debt of telecommunications companies. As we wrote in the August letter, "Wall Street is leading a massive borrowing and spending boom throughout the telecommunications and media sectors." With the Wall Street "money spigot" turned off, great disappointment has begun. Indeed, we see the disappointing earnings forecast by Alcatel, one of the world's largest telecommunications equipment companies, and the 38% one-day drop ($11 billion of market cap) in its stock as the first of many such announcements as the industry is forced to adjust to dramatically lower spending levels. In the same vein, the asset price bubble in media properties such as radio and television stations, billboards, sport franchises, internet businesses and cable properties is now destined for collapse.

What passed as the appearance of limitless amounts of capital, providing for endless asset inflation and spending in this field was but massive credit creation and unprecedented financial leveraging. And now, as we have predicted, losses are forcing deleveraging and position unwinds on many fronts. In Russia, Soros funds lost $2 billion; Tiger lost $600 million; the High Risk Opportunities Hub Fund appears to have suffered a complete loss on its $900 million; and the Everest Capital Fund lost almost $500 million, just to name a few. Leon Cooperman's Omega Advisors fund lost about $1 billion investing in Russia and emerging markets. One of the more stunning losses, however, belongs to Long-Term Capital Management, a hedge fund run by John Meriwether, former legendary trader at Solomon Brothers. A pioneer in fixed-income arbitrage, he and his partners including the Nobel laureates and fathers of derivative pricing Myron Scholes and Robert Merton, lost $2.5 billion, or fully 44% of their funds, in August and appear to be in jeopardy of a total loss. In their case, complex computer models went terribly wrong.

Speculators have also suffered attempting to profit from credit spreads. Leveraged holdings of junk bonds and asset-backed securities funded with borrowings from the money markets or through shorting government securities (repo trade) had all the appearance of free money. Instead, as government securities rallied sharply and credit spreads widened dramatically, this trade "blew up" with huge losses.

In yet another example of huge leveraged speculation gone bad, we see serious trouble developing with mortgage securities. Borrowing aggressively to leverage up to 10 times equity, a booming mortgage REIT (Real Estate Investment Trusts) industry has been a major buyer of risky residential and commercial debt securities. Now with losses for major residential REITs such as Capstead and Laser Mortgage and commercial REITs such as Imperial Credit and Criimi Mae, these companies are forced to deleverage. Recently, stocks have plummeted for the vast majority of mortgage origination companies including FirstPlus, Delta, United Companies Financial, AMRESCO, Contifinancial and Ocwen, that are involved in subprime, home equity, and commercial lending. We suspect that this is all part of deleveraging as well as investors shunning risky securities. Today the

market for commercial mortgages as well as debt issuance by REITs is dead, and we expect a similar fate soon for risky residential lending.

The "granddaddy" of problem speculations and coming unwinds, however, could prove to be the yen carry trade. With the dollar's sudden reversal of fortune, speculators have definitely been caught. Quickly admitting to $2 billion in losses during the first two weeks of September, Tiger fund operator Julian Robertson certainly does not believe he is the only major loser. We suspect this is but the first of what will prove to be a long list of huge losses as the dollar sinks and speculators abandon leveraged positions financed with borrowed yen. Importantly, this unwind will involve more deleveraging, potentially massive, of U.S., Latin America, and other securities globally with great potential to further destabilize an already impaired global financial system.

CONCLUSIONS

Holding stocks is now lunacy. The disaster predicted by us for a long time, is escalating with a speed that reveals the global financial system as a virtual house of cards. But among investors, greed has not yet been replaced by fear. It will be, eventually—at a much deeper market level.

Once a bear market has begun, "he who panics first, panics best." All of a sudden, the threats are multiplying: the Clinton impeachment scandal, a Chinese devaluation, a massive derivative accident, a worsening Russian crisis, plunging corporate profits, imploding Latin America, the Japanese financial system falling apart...

Compared with this rapidly growing number of threats, there is just one ray of hope: cuts in interest rates. In our view, they will be overwhelmed by the wholesale liquidity and wealth destruction unfolding in the markets. The only two historical precedents are America in the late 1920s and Japan in the late 1980s. Of these two, however, only the first was global.

As to investment recommendations, we can only repeat our suggestions of many months: cash and government bonds. We prefer first-class European bonds because the dollar is in for a sharp fall against the European currencies.

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